

BE VERY WARY OF EQUITY INDEXED ANNUITIES

by

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Be Very Wary of Equity Indexed Annuities
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Foreword

78 million Baby Boomers started to turn age 65 in 2011. Many of these Boomers will be seeking investments that have low risk and high returns. Equity indexed annuities are promoted as low risk investments with high returns. This short story explores the complexities and hidden costs of equity indexed annuities.

* * * * *

CHAPTER 1

Allure of Equity Indexed Annuities

When Helen Siswein, a retired teacher, heard about an investment that might earn as much as 8 percent a year and never lose money, she was sold. "I thought, 'Boy, if the market surges, I could make a lot,'" says Siswein, 82. In the summer of 2003, an insurance agent visited the widow at her former home in Bucks County, Pa. Upon the insurance agent's advice, she put about \$1 million into four annuities linked to stock market indexes.

Siswein says the agent didn't tell her she would be locking up most of her money until her 87th birthday. Or that there were caps on how much the investments could earn. Siswein was charged fees as high as 15 percent of her account balances to cash out early, in 2008, the contracts show. She says one annuity earned an average of about 3 percent a year after the penalties. The index it tracked, the Standard & Poor's 500-stock index, returned 6.3 percent including dividends in the same period. [1]

Siswein's story is typical of many older Americans who bought equity indexed annuities. After the Tech Wreck of 2000 and the Sub-Prime Crash of 2008, many investors are leery of investing in the stock market.

In recent years, CD's (Certificates of Deposit) have had relatively low annual returns.

When an insurance agent shows up at your door and tells you that he has an investment that will earn a guaranteed 3% a year plus even more if the stock market does well.....and is guaranteed not to lose money.....it is an alluring investment to unsophisticated investors.

Unfortunately, most insurance agents do not explain the rest of the story involved with equity indexed annuities. We will explore the rest of the story in upcoming chapters.

CHAPTER 2

Definition of Equity Indexed Annuities

Immediate Annuities

There are many different types of annuities. The annuity world can be split into two distinct groups. In my opinion, the first group can be thought of as Glenda, the Good Witch of the North. This first group is immediate or fixed annuities. With this type of annuity, an investor enters into a contract with an insurance company. The investor pays the insurance company a lump sum of money. In exchange for this lump sum of money, the insurance company agrees to pay the investor a fixed amount every month until the investor dies. These monthly payments begin immediately after the contract is completed, hence the name “immediate annuity”. [2]

There are many types of immediate annuities. A single life policy pays the annuity as long as the investor lives. There are also joint survivor type annuities where the annuity pays until the last surviving person dies. Of course, these joint survivor type annuities pay a lower amount each month than a single life policy. This is because the odds favor one of the two parties living longer than just one person. [3] In this short story, we will only be using single life type annuity contracts (for ease of illustration).

The amount of monthly income an immediate annuity pays is a function of current interest rates and expenses of the insurance company. Investors can use several web sites to shop for the highest paying immediate annuity. [4] In April 2007, the following rates were found assuming a \$100,000 immediate annuity was purchased by a male: [5]

Age	Annual Payout Ratio
40	6.00%
50	6.52%
60	7.34%
65	8.29%
70	9.26%
80	12.94%
90	21.00%

For example, a 65 year old male would receive 8.29% of \$100,000 or \$8,290 each year until he dies. The payout ratio increases with age because life expectancy decreases with age and the insurance company is required to pay the annuity for fewer years.

Investors shopping for immediate annuities are encouraged to search for reliable and low cost providers such as Vanguard, Fidelity, Berkshire Hathaway, and TIAA-CREF. [6]

If you would like to learn more about low-cost immediate annuities, read my short story titled ***Should Immediate Annuities Be a Tool in Your Retirement Planning Toolbox?***

Variable Annuities

In my opinion, the second group of annuities should be thought of as the Wicked Witch of the West. This group is the variable annuities group. The general concept of variable annuities is to increase the odds that investors will receive a higher payout than immediate annuities. The payout is higher because the insurance company invests in stocks or bonds selected by the investor. In theory, this concept is fine. In practice, high costs and complexity make these poor deals for investors. [7,8, and 9]

The sellers of variable annuities have intentionally made them difficult to understand. They skillfully hide all the fees and charges in such a manner no ordinary investor would ever understand them. [10]

McCann and Luo, two PhD's who have researched annuities, have an interesting observation about variable annuities. They say insurance companies add trivial insurance benefits, disadvantageous tax treatment, and exorbitant costs to mutual funds and then sell them as variable annuities. [11]

Warren Buffett is probably the greatest investor of all time. He is famous for one of his quotes, "Never invest in something you don't understand". Buffett escaped the dramatic losses incurred by Tech stock investors in 2000 because he did not understand and therefore never invested in Tech stocks.

I recommend that ordinary investors apply the Warren Buffett approach to variable annuities....don't invest in something you probably will never understand!

If you would like to learn more about variable annuities, read my short story titled ***Who Wins the Variable Annuity versus Mutual Fund Battle?***

Equity Indexed Annuities

From an investor's perspective, an equity indexed annuity is a type of variable annuity. It can't be a fixed type of annuity because its return is not fixed (it depends on the variation in the stock market). Since its return is variable, you would think it falls into the variable annuity camp.

Legally, an equity indexed annuity is classified as fixed type of annuity. We will see how and why we ended up with this legal classification in upcoming chapters.

In concept, an investor gives a chunk of money to an insurance company. The investor receives a minimum annual return, typically 3%. In addition, the investor receives some fraction of the annual increase in a stock market index.....typically the S&P 500. If the stock market declines in any given year, the value of the annuity does not decline. At the end of the annuity

contract, anywhere from five to 20 years, the investor receives his money back plus any growth in account value.

Unfortunately, the devil is in the details with equity indexed annuities. We will examine these details in an upcoming chapter.

CHAPTER 3

Regulation of Equity Indexed Annuities

Three Types of Financial Planners

There are three different types of people selling investments. A 2011 GAO paper does a nice job of summarizing these three groups. [12]

The first group is financial planners. This group is governed at the federal level by the *Investment Advisers Act of 1940* and rules from the SEC. It is also governed at the state level by state securities laws.

This group is also bound to a fiduciary standard with respect to their conduct with their clients. This group must put the customer's interests above their own interests. They must also disclose any conflicts of interest to the customer.

The second group is broker-dealers. The general public would call these stock brokers. They are governed by the *Securities Act of 1934* and rules of FINRA and the SEC. They also must comply with state securities laws.

This second group is bound by the suitability standard with respect to their conduct with their clients. They may sell investments which are in the best interest of themselves versus their clients as long as the investments are deemed suitable. They do not have to act in a fiduciary manner with their clients. They also do not have to disclose any conflicts of interest to their customers.

The third group is insurance agents. They are governed by state insurance laws. They do not operate as fiduciaries and have no suitability requirement. They also do not have to disclose conflicts of interests to their customers.

Variable Annuities

Because variable annuities usually invest in stock mutual funds, sellers of variable annuities must have the appropriate licensing for selling stock related products. Insurance agents selling variable annuities must be licensed as brokers. They are regulated similar to the broker-dealer group described above including the suitability versus fiduciary standard.

Fixed Annuities

Fixed annuities, such as immediate annuities, are treated as an insurance product. Insurance agents can sell fixed annuities. Agents are only regulated by state insurance requirements. There is no suitability or fiduciary standard.

Equity Indexed Annuities

To an ordinary investor, one would think that equity indexed annuities are also regulated as variable annuities since their return is not fixed and their value depends on an underlying stock market index. This is an invalid assumption!

When equity indexed annuities were first sold back in 1995, they were classified as a form of fixed annuity. This allows insurance agents to sell them, and avoid licensing as stock brokers. It also negates the suitability requirement.

SEC Efforts to Regulate Equity Indexed Annuities

Because of abusive selling practices of equity indexed annuities, a few years ago the SEC tried to regulate equity indexed annuities. The insurance industry fought this change tooth and nail.

Last Minute Escape from Dodd-Frank Bill

The Sub-Prime Crash of 2008 prompted Congress to draft new regulations governing our financial markets. This led to the ***Dodd-Frank Wall Street Reform and Consumer Protection Act*** being passed in 2010.

Initially, the bill called for regulation of equity indexed annuities by the SEC. This would be a blow to the many

insurance companies located in Iowa. At the last minute, Senator Tom Harkin of Iowa filed an amendment to exempt regulation of equity indexed annuities as securities. [13]

Below is an excerpt from a press release describing how insurance companies were saved at the last minute.

In a major surprise to the annuity and financial community, equity indexed annuities were specifically provided favorable regulatory treatment in today's Financial Reform Bill.

That treatment, which was clearly headed for a change before the new law with the SEC prepared to reclassify equity indexed-annuities as securities starting in 2011. The SEC's plan was derailed this week, however, now that Congress has voted to maintain the current setup in which state insurance regulators oversee the products. That revised approach and language, which came in the form of a surprise amendment to the financial reform bill, was offered by Sen. Tom Harkin, D-Iowa., who argued that annuities are insurance products, not securities.

As part of the Wall Street overhaul process, companies that offer equity-indexed annuities, alongside state insurance commissioners, had aggressively pushed for state regulation of the products instead of federal SEC regulation.

However, the SEC decided in a ruling known as "151a" to treat the products as securities investment products, arguing they are both securities and a form of insurance. The commission opposed congressional efforts to remove them from SEC regulation. Supporters of the exemption disagreed with the SEC's ruling and pushed lawmakers to ensure the products are treated as insurance products, which are traditionally regulated at the state level.

The move came over strong objections by the House Financial Services Committee Chairman Barney Frank (D-Mass.), the SEC, consumer advocacy groups, state securities administrators and financial planners. The Certified Financial

Planner Board of Standards, Inc., Consumer Federation of America, Financial Planning Coalition, among others argued the legislation weakens investor protection.

From an investor's point of view, exemption of equity indexed annuities from being regulated as securities is a major loss. Insurance agents selling equity indexed annuities do not have any fiduciary or even suitability requirement towards their customers.

CHAPTER 4

Understanding the Fine Print of Equity Indexed Annuities

Simple Concept

Remember the simple concept of an equity indexed annuity that was described in Chapter 2 above?

In concept, an investor gives a chunk of money to an insurance company. The investor receives a minimum annual return, typically 3%. In addition, the investor receives some fraction of the annual increase in a stock market index.....typically the S&P 500. If the stock market declines in any given year, the value of the annuity does not decline. At the end of the annuity contract, anywhere from five to 20 years, the investor receives his money back plus any growth in account value.

Now we will examine the fine print of these investments.

Surrender Charges

Most people are familiar with CD's (Certificates of Deposit). You give the bank a lump sum of money and agree to leave it with the bank for a set time period. The bank agrees to pay you a certain rate of interest on your deposit.

If you decide to withdraw the money from the CD account before the agreed upon time period is completed, you must pay an early withdrawal penalty. This is typically 30 to 90 days worth of interest for CD's with a term of less than one year. For CD's with a term longer than a year, you can expect to pay at least 90 days worth of interest. [14]

For most investors, the CD early withdrawal penalty is not deemed as excessive. You give up some interest, but your principal is still intact.

For equity indexed securities, the early withdrawal penalty is renamed to a surrender charge.

Equity indexed annuities have surrender charges frequently of 10% to 12% of your investment. [15] The surrender charges can be as high as 16%. [16] The surrender charges usually decline over a period of years. On some contracts, the surrender charges last throughout the contract's life, making the contract's cash surrender value less than the premiums paid for many years! [17]

The early withdrawal penalties for equity indexed annuities are at least an order of magnitude higher than CD's. Instead of losing a little interest on a CD, you can lose 12% of your principal on an equity indexed annuity!

Life is uncertain. Many people encounter unforeseen circumstances where they need access to cash immediately. If you invest in an equity indexed annuity, you will have a heavy toll if you need your money for an emergency.

Many insurance sales personnel tout equity indexed annuities as an investment where you can not lose money. They forget to tell you the caveat that goes with this statement.....*as long as you don't need your money over the term of the investment.*

Guaranteed Minimum Rates of Return

Many equity indexed annuities offer a nominal 3% minimum rate of return. An ordinary investor would assume the insurance company pays 3% every year on the amount invested in the equity indexed annuity.

Unfortunately, this is not always true. Sometimes the guaranteed rate of return is only applied to a fraction of the money invested. Sometimes the interest is not compounded either. On some contracts, no interest is credited unless the annuity is held until maturity. [18]

Stock Index Dividends Not Included

Usually the S&P 500 is the stock index used for equity indexed annuities. The S&P 500 is made up of 500 large companies (not

the 500 largest) selected by a committee. The S&P 500 typically represents about 80% of the value of all U.S. stocks.

The total return of an S&P 500 index fund is the sum of the change in value of the 500 stocks plus any dividends paid. Dividends historically account for roughly 20% of the annual total return for the S&P 500.

In most equity indexed annuities, the insurance company, not the investor, gets to keep all stock dividends each year. [19] In effect, the insurance company is lowering your return by 20% because they keep the stock dividends.

Investors Only Get Credit for a Fraction of the Stock Market Return

In most equity indexed annuities, the investor does not get credit for 100% of the stock market return. [20] The investor gets some percentage less than 100%, with the balance going to the insurance company.

Insurance companies name this phenomenon *the participation rate*. If the participation rate is 80% and the stock market return is 10%.....the investor gets credit for 8% and the insurance company gets credit for 2%.

Measuring Changes in the Stock Market Index

One would think that measuring the change in the underlying stock market index would be easy. Let us assume the equity indexed annuity contract uses the S&P 500 as the underlying index. Let us assume that you invested in an equity indexed annuity on July 1.

For year one of your annuity, the S&P 500 gained 10% from January 1 thru December 31. Since you were only invested for half of that year, you are given credit for half of the annual return, or 5%.

In year two, you are invested for the full year. The annual change is calculated by subtracting the S&P 500 index level at January 1 from the index level on December 31. Your account

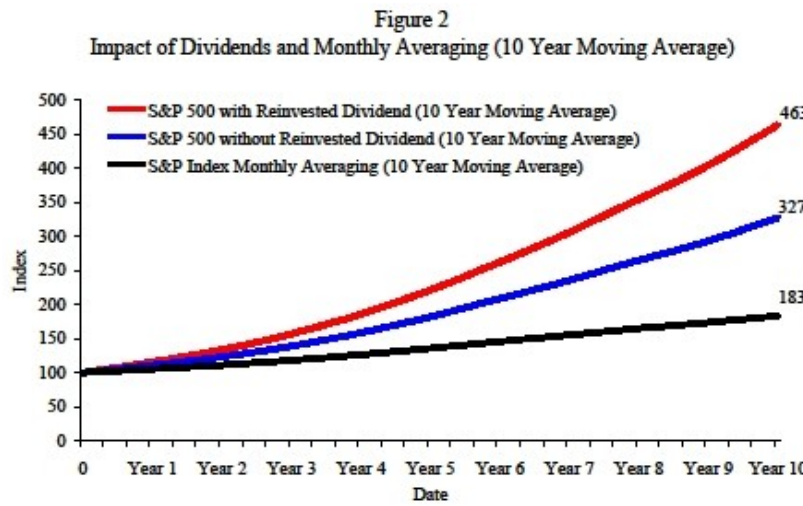
is credited for the index level change for year two. Subsequent years are done the same way.

Unfortunately, very few equity indexed annuities are done this way. Insurance companies have dreamed up at least three different ways of computing the annual change in the index. [21]

These three methods are complicated and tend to favor the insurance company. The first method is point-to-point where the increase in the index is measured from the contract start date to the contract end date.

The second method is point-to-point with an annual reset of the change in index value. The third method is the monthly average return method. This is the most complicated methodology and the worst method from an investor's viewpoint.

McCann and Luo's paper on equity indexed annuities showed the impact of two key factors. These include not getting credit for stock dividends and employing the least favorable method of crediting annual increases in the stock market (the monthly averaging method).[22]



Unsophisticated investors might believe that they will get 100% of the increase from 100 to 463 when in fact they receive only 23% of this increase.

Spreads, Caps, and Fees

The change in the stock market index is usually multiplied by the participation rate to determine the amount of gain credited to the investor. Sometimes an additional multiplier is used called a *spread*. The spread can be as great as 3%. [23]

The introduction of this spread factor by the insurance company adds additional complexity. It means that two contracts that are linked to the same stock market index, with the same indexing method and participation rate can have significantly different net returns to the investor.

Caps are used to reduce the credited stock market index changes on some annuities. For example, let us assume a cap factor of 14%. In years where the stock market return exceeds 14%, the investor is only credited with 14%.

The average long term return of the stock market is dramatically impacted by a few years with very large returns. The price appreciation in the S&P 500 from 1975 to 2004 was 10%. If the yearly increase is capped at 14%, the investor would have received only 5.5% annualized appreciation.

Net Result of the Fine Print in Equity Indexed Annuities

Insurance companies intentionally made equity indexed annuities difficult to understand. In the paper by McCann and Luo, they conclude: [24]

Equity-indexed annuities are complicated investments sold to unsophisticated investors without the regulatory safeguards afforded to purchasers of similar investments. If brokers and agents told investors of the effect equity-indexed annuities' shaving of index returns and extraordinary costs the market for these products would dry up.

Ironically, both the SEC and the NASD caution investors to review and understand the impact on likely returns of the myriad equity-indexed annuity features. No registered rep, insurance broker, or retail investor, and precious few finance PhDs, could understand these products. The net result of equity-indexed annuities' complex formulas and hidden costs is that they survive as the most confiscatory investments sold to retail investors.

The financial studies done by McCann and Luo lead them to an interesting observation:

We estimate that between 15% and 20% of the premium paid by investors in equity-indexed annuities is a transfer of wealth from unsophisticated investors to insurance companies and their sales forces.

CHAPTER 5

Big Commissions of Equity Indexed Annuities

Certificate of Deposits

You can go to your bank and buy a CD. There is no sales commission since you bought it directly from the bank. There is no annual expense fee. If you withdraw your money before the term of the CD is up, you will lose some interest on your CD.

Load Stock Mutual Funds

When a commission based salesperson sells an investor a load stock mutual fund, the salesperson and his firm receive a typical commission of 5.5% of the investment.

If you invest \$100,000 in a loaded stock mutual fund, \$5500 goes to the salesperson and his firm.....leaving you with \$94,500 invested in the fund.

Loaded stock funds also have typical annual expenses of 1.5% of the investment. For an invested amount of \$94,500.....you also pay \$1,418 in annual expense fees.

Usually you can withdraw your money from the fund at any time with no early withdrawal fee.

No-Load Stock Mutual Funds

Let us assume you buy \$100,000 worth of the ***Total Stock Market*** index fund (symbol VTSAX) directly from Vanguard. You pay \$0 in commission since you bought it directly from Vanguard. Because you invested more than \$10,000 in the Total Stock Market fund, your annual expense ratio is only 0.07%. This means you only pay Vanguard \$70 in annual expenses.

You can withdraw your money from the fund at any time with no early withdrawal fee.

An investment in a bond index fund, like the ***Total Bond*** fund at Vanguard has similar annual expense ratios and no early withdrawal fees.

Equity Indexed Annuity

The salesperson that sells you the equity indexed annuity typically receives a commission of 10% to 12% of the amount invested. If you invest \$100,000 in an equity indexed annuity, the salesperson will receive \$12,000 if the commission rate is 12%.

It is difficult to compute the equivalent annual expense ratio for an equity indexed annuity. If you combine all the items noted above in the fine print of the contract, you are paying 15% to 20% of your investment to the insurance company. [25]

The early withdrawal penalty can range from 10% to 16% of the investment. If you invest \$100,000.....the early withdrawal penalty can be \$16,000 if the penalty is 16%.

Conflict of Interest

The high commission paid by insurance companies for selling equity indexed annuities naturally drives a conflict of interest between the salesperson and the customer.

Now pretend that you are an insurance salesperson paid on commission. If you find a client with \$100,000 to invest.....are you going to recommend the no-load index fund where you receive \$0 or the equity indexed annuity where you receive \$12,000?

CHAPTER 6

Abusive Selling Practices

The relatively high commissions paid by insurance companies for selling equity indexed annuities and lack of regulation drives abusive selling practices.

Senior citizens have been targets of abusive selling practices for equity indexed annuities. The abuses became so widespread that FINRA (Financial Industry Regulatory Authority) issued an Investor Alert on equity indexed annuities. [26] Below is the lead-in paragraph of the Investor Alert:

Why an Alert on Equity-Indexed Annuities?

Sales of equity-indexed annuities (EIAs)—also known as "fixed-indexed insurance products" and "indexed annuities"—have grown considerably in recent years. Although one insurance company at one time included the word "simple" in the name of its product, EIAs are anything but easy to understand. One of the most confusing features of an EIA is the method used to calculate the gain in the index to which the annuity is linked. To make matters worse, there are not one, but several different indexing methods. Because of the variety and complexity of the methods used to credit interest, investors will find it difficult to compare one EIA to another.

Before you buy an EIA, you should understand the various features of this investment and be prepared to ask your insurance agent, broker, financial planner or other financial professional lots of questions about whether an EIA is right for you.

This alert also disputes the common sales pitch that you can not lose money on an equity indexed annuity:

Is it possible to lose money in an EIA?

Yes. Many insurance companies only guarantee that you'll receive 90 percent of the premiums you paid, plus at least 3 percent interest. Therefore, if you don't receive any index-linked interest, you could lose money on your investment. One way that you could not receive any index-linked interest is if the index linked to your annuity declines. The other way you may not receive any index-linked interest is if you surrender your EIA before maturity. Some insurance companies will not credit you with index-linked interest when you surrender your annuity early.

CHAPTER 7

Dateline Exposé

Free Steak Dinner

On April 13, 2008, Dateline aired a story exposing abusive sales practices of equity indexed annuity sales personnel titled *Tricks of the Trade*. [27]

Dateline first attended a meeting where a local insurance agent had invited people to an invitational meeting on investments.....where they got a free steak dinner.

The insurance agent started out by trying to scare the attendees by proclaiming that banks were no longer a safe place to keep your money. Of course, he failed to say that no customer has ever lost a dime in an FDIC insured bank account.

The agent next promised big returns by investing in something called an indexed annuity.

The last step for the agent was to tout that investors in equity indexed annuities can't lose a dime. Of course he failed to mention that you have to leave your money invested for many years.....and you face surrender penalties as high as 20% if you try to take out your money early.

Going Under-Cover in a Rented House

Dateline then rented a house near Birmingham, Alabama. They wired it for sound and video. They also found a volunteer male in his 70s to portray the potential customer.

Most insurance agents who came to the house didn't mention the huge surrender penalties. When the volunteer questioned them specifically about the surrender charges, some salesmen simply didn't answer the question and changed the subject.

School for Equity Indexed Insurance Salesmen

Tyrone Clark is the self-proclaimed ***King of Annuity Sales***. He runs a school in Alabama designed to teach insurance agents how to sell more equity indexed annuities.

Because his school is only open to licensed insurance agents, Dateline worked with the State of Alabama to get insurance licenses issued to two Dateline employees. The Dateline employees had hidden microphones and cameras.

Clark taught the use of scare tactics as the step in selling senior citizens equity indexed annuities. He suggested that insurance salesmen proclaim that banks are unsafe. He also suggested that salesmen prey on senior citizens fear of being placed in a nursing home.

Clark suggested that equity indexed annuities be promoted on the basis of ease of investors getting their money. In reality, investors lock up their money for years unless they pay exorbitant surrender penalties.

Clark also suggested that insurance agents portray themselves as financial experts by either writing books or getting their face printed on the cover of a magazine. Dateline found vendors at the training class that would generate books or fake magazine covers for the insurance agents. Vendors would also arrange for fake radio interviews which could be burned onto CD's and given to customers.

The Dateline producer even had his picture placed on a magazine cover as a financial expert. He showed it to an insurance agent that was trying to use his fake magazine cover to convince a customer that he was an investment expert.

Comments

Watching the Dateline video or reading the show transcript is fascinating. It shows the steps that many insurance agents will take to try to achieve those huge 10% to 12% commissions for selling equity indexed annuities.

My personal experience is that any profession has members whose behavior follows a normal distribution curve. For example, if the profession is one that involves being

compassionate to people.....you might have one person who is a saint.....like Mother Theresa. You might have an absolute scum of the earth like John Wayne Gacy. Most people fall in the middle somewhere.

The huge financial reward for selling equity indexed annuities shifts the whole normal distribution to the bad side with respect to investors. Many insurance agents will not touch equity indexed annuities because they know how bad they are for the customer. Some agents swallow their misgivings about them and proceed to sell them because of the huge financial reward.

CHAPTER 8

Other Opinions about Equity Indexed Annuities

Google

Googling the term “problems with equity indexed annuities” yields 16,400 hits. Obviously there are a lot of problems with equity indexed annuities.

List of People Warning About Equity Indexed Annuities

NAFA (National Association for Fixed Annuities) is an insurance industry trade group. Their web site has a list of negative articles on equity indexed annuities that they have responded to. This list reads like a who’s-who list of financial planning organizations: [28]

Times Free Press article by Chris Hopkins.

Motley Fool article by Dan Caplinger.

Money Magazine article by Lisa Gibbs.

Investment News article by Jim Pavia.

Bloomberg article by Margaret Collins.

Article by Scott Burns.

Forbes.com article about Bogleheads View Article.

Article in Barron’s editorial page.

Article by Humberto Cruz.

Somebody needs to explain to the NAFA that when you have this many financial planning people and organizations pointing out the deficiencies of equity indexed annuities.....you are tilting against windmills trying to rebut all of them!

In addition, the FINRA Investor Alert also pointed out the complexity and difficulty of understanding equity indexed annuity contracts.

An Attempt to Portray Equity Indexed Annuities in a Favorable Light

The March 2011 issue of the Journal of Financial Planning has an article titled ***Real-World Index Annuity Returns*** by Geoffrey VanderPal, Jack Marrion, and David F. Babbel. [29]

In any article or study, a good indicator of any potential bias in the study, can be found from examining the background of the authors. VanderPal was a financial planner and insurance agent in Las Vegas. He is now working for a new firm in Texas that specializes in selling equity indexed annuities. Marrion writes books about annuities and Babbel is a Professor of Insurance.

The article starts with an argument that writers about equity indexed annuities are incorrect about their negative conclusions because stock market returns are not normally distributed. It is true that daily, weekly, or monthly stock market returns are not normally distributed. But my research has shown that annual stock market returns are normally distributed.

If you are a long term investor, all you care about is annual versus daily or monthly returns. If equity indexed annuities were calculated using annual stock market index returns, the returns would be normally distributed. If equity indexed annuities use some kind of monthly scheme to credit changes in the stock market index to an account, then monthly returns are not normally distributed.

To learn more about the normal distribution of annual stock market returns, you can read my short story titled ***Are Black Swans Really Harmful to Ordinary Investors?***

The authors of this article contacted 15 insurance companies that sell equity indexed annuities. The insurance companies provided copies of actual equity indexed annuity contracts to the authors with the contract owner's name blacked out. The authors admit that this is not a random sample. They also

admitted the insurance companies could have selected the equity indexed annuities that were most favorable to investors versus the insurance company.

Imagine that you are the CEO of an insurance company selling equity indexed annuities. Your assistant tells you that three supporters of the insurance industry have requested copies of customer's contracts. Your assistant says these authors want to write an article favorable to equity indexed annuities. What type of information are you going to provide these three authors? My guess is that you are only going to provide copies of the annuity contracts that were most favorable to the investors versus the insurance company.

Ideally, the entire universe of existing equity indexed annuities would have been studied. Or alternatively, the universe of all indexed annuity contracts would be randomly sampled. This the random sample would be used to statistically describe the entire universe of contracts.

The three authors then constructed a table showing the actual compounded rates of return earned by equity indexed annuity customers over five year periods. The authors state the returns do account for fees.....but it is unclear if they are counting the initial 10% to 12% sales commission or they are referring to other fees. The returns calculated also did not include the impact of customers who redeemed early and paid surrender charges. Their return table is shown below. CAGR is compounded annual return.

Period	CAGR of Equity Indexed Annuity
1997-2002	9.19%
1998-2003	5.46%
1999-2004	4.69%
2000-2005	4.33%
2001-2006	4.36%
2002-2007	6.12%
2003-2008	6.05%
2004-2009	4.19%
2005-2010	3.89%

An alternative to purchasing an equity indexed annuity would be to invest in a very simple Vanguard two-fund portfolio of index funds. The stock fund would be the Total Stock Market Index Fund (VTSMX) and the bond fund would be the Total Bond Fund (VBMFX). A conservative asset allocation would be 50% invested in the stock fund and 50% invested in the bond fund.

Using historic returns data, we can compare the performance of this very simple two-fund portfolio to the equity indexed annuity. [30] We will also calculate the standard deviation of this simple two-fund portfolio to give an idea of the risk involved.

Period	CAGR of Equity Indexed Annuity	CAGR of 50:50 Vanguard Total Stock Market and Total Bond Fund	Sigma of 50:50 Vanguard Total Stock Market and Total Bond Fund
1997-2002	9.19%	6.74%	10.62%
1998-2003	5.46%	6.32%	10.01%
1999-2004	4.69%	5.06%	8.98%
2000-2005	4.33%	3.84%	8.41%
2001-2006	4.36%	5.42%	8.52%
2002-2007	6.12%	6.66%	7.87%
2003-2008	6.05%	5.06%	11.30%
2004-2009	4.19%	5.00%	11.22%
2005-2010	3.89%	5.56%	11.51%

In six of the nine rolling 5 year periods studied, the simple two-fund indexing approach gave higher returns than the EIA.

When many index funds are used in a portfolio, it is often called a slice-n-dice portfolio. Rather than using a simple two-fund approach, we could slice-n-dice and invest in seven different index funds. We could invest 15% in the Total Stock Market fund (VTSMX), 5% in the REIT fund (VGSIX), 10% in Emerging Markets (VEIEX), 10% in the International Pacific fund (VPACX), 10% in the International European fund (VEURX), 25% in the Total Bond Fund (VBMFX), and 25% in the TIPS fund (VIPSX). The historic rolling five year returns and sigmas of this slice-n-dice portfolio are shown below:

Period	CAGR of Equity Indexed Annuity	CAGR of 50:50 Vanguard Total Stock Market and Total Bond Fund	Sigma of 50:50 Vanguard Total Stock Market and Total Bond Fund	CAGR of 7-Fund Slice-n- Dice Portfolio	Sigma of 7-Fund Slice-n- Dice Portfolio
1997-2002	9.19%	6.74%	10.62%	4.80%	8.12%
1998-2003	5.46%	6.32%	10.01%	7.28%	11.06%
1999-2004	4.69%	5.06%	8.98%	8.34%	11.30%
2000-2005	4.33%	3.84%	8.41%	6.76%	10.18%
2001-2006	4.36%	5.42%	8.52%	9.29%	9.29%
2002-2007	6.12%	6.66%	7.87%	11.35%	7.47%
2003-2008	6.05%	5.06%	11.30%	8.05%	14.60%
2004-2009	4.19%	5.00%	11.22%	8.03%	14.58%
2005-2010	3.89%	5.56%	11.51%	7.69%	14.47%

The seven fund slice-n-dice portfolio achieved a higher historic return in eight out of nine rolling five year periods studied.

My conclusion about this paper is that it fails to make the case for equity indexed annuities. The first major problem with this paper is that all three authors have a natural bias in favor of equity indexed annuities. They have this natural bias because they all work in the insurance field.

The second major problem is the sample of equity indexed contracts used was not statically valid. A random sample of all equity indexed annuity contracts was not used for the study. Not all equity indexed annuity contracts were used either. The contracts that were used could have been “cherry picked” by the insurance companies to be most favorable to investors.

The third major problem is the rolling five year returns given as an example of equity indexed annuity performance. These returns were less than low-cost portfolios of index funds. A simple two fund indexing approach beat the return of the equity indexed annuities 67% of the time. A seven fund slice-n-dice indexing approach beat the return of the equity indexed annuities 89% of the time.

The fourth problem is that a time period was selected which is most favorable to equity indexed annuities. Per the McCann and Luo paper, equity indexed annuities with longer maturities

provide less value to investors than annuities with shorter annuities. Five year performance was used for this paper. Performance results for longer time periods should have also been used in the paper.

The fifth problem is that it is not clear whether the 10% to 12% initial sales commission was figured into the return of the equity indexed annuities. Let us use the example of a five year investment with a 0% sales commission and a 5% compounded return. If you must pay a sales commission of 12%, the effective compounded return is reduced from 5% to only 2.35%. Initial commissions have a huge impact on investor returns.

The sixth problem is that actual historical return information, including commissions and all expenses, is not available to the general public. The actual historical return information for stock and bond mutual funds is available to the general public for review.

Low-cost index fund portfolios have historically given higher returns than the example equity index annuities used in this paper. Therefore, there is little reason for investors to purchase complicated equity indexed annuities with their exorbitant surrender charges. The low-cost index fund portfolios have no surrender charges and you can get your money back penalty free at any time.

CHAPTER 9

Better Options

There are much better options than equity indexed annuities, depending on what your goal is.

Certificates of Deposit

If you are primarily concerned about the safety of your principal, bank CD's are an excellent choice. As long as you stay under the FDIC limits for deposit insurance, your investment should be safe.

Some people are concerned that they have more to invest than the current FDIC limits. Most banks participate in a program where they spread your money around to different banks so all of your money is FDIC insured.

Although CD's will not keep up with inflation and taxes over the long-term, this is the lowest risk method of investing.

Low-Cost Immediate Annuities

If you are a senior citizen and you need more income, low-cost immediate annuities are a good option. However, utilizing a low-cost immediate annuity means leaving less money to your heirs.

With a low-cost immediate annuity, you give a lump sum of your money to an insurance company. The insurance company agrees to send you a monthly check until you die. Once you give your money to the insurance company, you can not get it back. I would suggest a low-cost immediate annuity that is indexed to inflation in case inflation picks up in the future.

Low-Cost Index Mutual Funds

If your goal is to maximize the return on your money with a reasonable level of risk, you can utilize a simple two-fund indexing approach.

In the McCann and Luo paper on equity indexed annuities, they point out how well a simple two asset class portfolio performs compared to an equity indexed annuity. They utilize a portfolio invested 60% in U.S Treasury Strips and 40% in a low-cost stock index fund. They find that 96.9% of the time, the simple Treasury and stock index fund outperform the equity indexed annuity. They also found the typical after-tax return of an equity indexed annuity will only be 30% of the after-tax return of the index fund option.

An investor could choose a portfolio made up of two Vanguard Funds. These two funds would be the Total Stock Market fund and the Total Bond Fund. For the time period of 1972 to 2010, a portfolio of these two funds historically returned about 10% annually (with an asset allocation of 40:60 to 60:40 stock-to-bond ratio). Although historic returns are not necessarily a predictor of future returns, a low risk portfolio like a 40:60 stock-to-bond ratio should perform reasonably well in the future. If you are concerned about future inflation, the fixed income portion of the portfolio can be invested in Vanguard's TIPS fund. TIPS are indexed to inflation.

An investor could also choose to use a slice-n-diced approach to their index fund portfolio. Historically, a slice-n-diced portfolio has given a slightly higher return than a simple two-fund approach. For more information about sliced-n-dice index fund portfolios, read my short story titled ***Total Market or Slice-n-Dice for My Investment Portfolio?***

CD Coupled with Low-Cost Index Fund

In the April 2011 issue of Financial Planning magazine, Allan Roth authored an article titled ***DIY Annuity: Combined a certificate of deposit with a stock index fund can bring peace of mind, without the fees.***

Roth's concept is to buy a 10 year CD that has a value at maturity equal to the original total portfolio. Then take the balance of the initial portfolio and invest it in a Vanguard low-cost stock index fund.

If the investor believes the stock market might go to zero value in 10 years, the CD will mature to the starting portfolio value. No money is lost (except for inflation and taxes).

Another option is to design the portfolio so you maintain its starting value even if the stock market declines by 50% over the ten years.

Although Roth's article includes a summary spreadsheet, I constructed a more detailed spreadsheet explaining his concept. In this spreadsheet, a -100% stock market return means the stock market goes to zero value at the end of 10 years. A -6.7% annual stock market return is equivalent to the stock market declining by 50% in value over the 10 years. Roth's baseline case where the investor does not want to lose money if the stock market goes to zero value is shown below:

Stock Market Return	Amount Invested in 10 Year CD @ 3.25% Rate	Amount Invested in Vanguard Total Stock Market Fund	Stock to Bond Ratio	Ending Value of CD	CD & Total Stock Market		
					Ending Value of Vanguard Total Stock Market Fund with .07% ER	Total Ending Value of Combination CD and Total Stock Market Fund	Entire Portfolio Com- pounded Annual Return Rate
-100%	\$72,627	\$27,373	27:73	\$100,000	\$0	\$100,000	0.0%
-6.70%	\$72,627	\$27,373	27:73	\$100,000	\$13,579	\$113,579	1.3%
-6%	\$72,627	\$27,373	27:73	\$100,000	\$14,634	\$114,634	1.4%
-4%	\$72,627	\$27,373	27:73	\$100,000	\$18,066	\$118,066	1.7%
-2%	\$72,627	\$27,373	27:73	\$100,000	\$22,206	\$122,206	2.0%
0%	\$72,627	\$27,373	27:73	\$100,000	\$27,182	\$127,182	2.4%
2%	\$72,627	\$27,373	27:73	\$100,000	\$33,139	\$133,139	2.9%
4%	\$72,627	\$27,373	27:73	\$100,000	\$40,247	\$140,247	3.4%
6%	\$72,627	\$27,373	27:73	\$100,000	\$48,698	\$148,698	4.0%
8%	\$72,627	\$27,373	27:73	\$100,000	\$58,714	\$158,714	4.7%
10%	\$72,627	\$27,373	27:73	\$100,000	\$70,548	\$170,548	5.5%
12%	\$72,627	\$27,373	27:73	\$100,000	\$84,487	\$184,486	6.3%
14%	\$72,627	\$27,373	27:73	\$100,000	\$100,856	\$200,856	7.2%
16%	\$72,627	\$27,373	27:73	\$100,000	\$120,027	\$220,027	8.2%
18%	\$72,627	\$27,373	27:73	\$100,000	\$142,418	\$242,418	9.3%
20%	\$72,627	\$27,373	27:73	\$100,000	\$168,500	\$268,500	10.4%

For comparison purposes, we could invest 73% of the portfolio in the Vanguard Total Bond Fund. We could invest 27% in the Vanguard Total Stock Fund. Below are the ending portfolio values and compounded returns:

Stock Market Return	Total Bond & Stock Market			Ratio of CD and Total Stock Fund to Total Bond and Total Stock Funds
	Ending Value of Total Bond Fund with 5% return	Total Ending Value of Combination Total Bond and Total Stock Market Funds	Entire Portfolio Com- pounded Annual Return Rate	
-100%	\$117,515	\$117,515	1.6%	85%
-6.70%	\$117,515	\$131,095	2.7%	87%
-6%	\$117,515	\$132,150	2.8%	87%
-4%	\$117,515	\$135,582	3.1%	87%
-2%	\$117,515	\$139,722	3.4%	87%
0%	\$117,515	\$144,697	3.8%	88%
2%	\$117,515	\$150,655	4.2%	88%
4%	\$117,515	\$157,762	4.7%	89%
6%	\$117,515	\$166,214	5.2%	89%
8%	\$117,515	\$176,230	5.8%	90%
10%	\$117,515	\$188,063	6.5%	91%
12%	\$117,515	\$202,002	7.3%	91%
14%	\$117,515	\$218,372	8.1%	92%
16%	\$117,515	\$237,543	9.0%	93%
18%	\$117,515	\$259,934	10.0%	93%
20%	\$117,515	\$286,016	11.1%	94%

Note that the two-fund approach always gives a higher ending portfolio value and higher compounded return than the Roth CD and index fund combination. This ratio is in the right hand column above.

Roth’s second option is designed not to lose money if the stock market loses 50% of its value over 10 years. It is shown below:

Stock Market Return	Amount Invested in 10 Year CD @ 3.25% Rate	Amount Invested in Vanguard Total Stock Market Fund	Stock to Bond Ratio	Ending Value of CD	CD & Total Stock Market		
					Ending Value of Vanguard Total Stock Market Fund with .07% ER	Total Ending Value of Combination CD and Total Stock Market Fund	Entire Portfolio Com- pounded Annual Return Rate
-100%	\$57,019	\$42,981	43:57	\$78,509	\$0	\$78,509	-2.4%
-6.70%	\$57,019	\$42,981	43:57	\$78,509	\$21,322	\$99,831	0.0%
-6%	\$57,019	\$42,981	43:57	\$78,509	\$22,978	\$101,488	0.1%
-4%	\$57,019	\$42,981	43:57	\$78,509	\$28,367	\$106,877	0.7%
-2%	\$57,019	\$42,981	43:57	\$78,509	\$34,869	\$113,378	1.3%
0%	\$57,019	\$42,981	43:57	\$78,509	\$42,681	\$121,190	1.9%
2%	\$57,019	\$42,981	43:57	\$78,509	\$52,035	\$130,544	2.7%
4%	\$57,019	\$42,981	43:57	\$78,509	\$63,195	\$141,705	3.5%
6%	\$57,019	\$42,981	43:57	\$78,509	\$76,466	\$154,975	4.5%
8%	\$57,019	\$42,981	43:57	\$78,509	\$92,193	\$170,702	5.5%
10%	\$57,019	\$42,981	43:57	\$78,509	\$110,774	\$189,283	6.6%
12%	\$57,019	\$42,981	43:57	\$78,509	\$132,660	\$211,170	7.8%
14%	\$57,019	\$42,981	43:57	\$78,509	\$158,364	\$236,874	9.0%
16%	\$57,019	\$42,981	43:57	\$78,509	\$188,467	\$266,976	10.3%
18%	\$57,019	\$42,981	43:57	\$78,509	\$223,625	\$302,134	11.7%
20%	\$57,019	\$42,981	43:57	\$78,509	\$264,579	\$343,088	13.1%

For comparison purposes, we could invest 57% of the portfolio in the Vanguard Total Bond Fund. We could invest 43% in the Vanguard Total Stock Fund. Below are the ending portfolio values and compounded returns:

Stock Market Return	Total Bond & Stock Market			Ratio of CD and Total Stock Fund to Total Bond and Total Stock Funds
	Ending Value of Total Bond Fund with 5% return	Total Ending Value of Combination Total Bond and Total Stock Market Funds	Entire Portfolio Com- pounded Annual Return Rate	
-100%	\$92,261	\$92,261	-0.8%	85%
-6.70%	\$92,261	\$113,583	1.3%	88%
-6%	\$92,261	\$115,239	1.4%	88%
-4%	\$92,261	\$120,628	1.9%	89%
-2%	\$92,261	\$127,129	2.4%	89%
0%	\$92,261	\$134,942	3.0%	90%
2%	\$92,261	\$144,296	3.7%	90%
4%	\$92,261	\$155,456	4.5%	91%
6%	\$92,261	\$168,726	5.4%	92%
8%	\$92,261	\$184,454	6.3%	93%
10%	\$92,261	\$203,035	7.3%	93%
12%	\$92,261	\$224,921	8.4%	94%
14%	\$92,261	\$250,625	9.6%	95%
16%	\$92,261	\$280,727	10.9%	95%
18%	\$92,261	\$315,885	12.2%	96%
20%	\$92,261	\$356,839	13.6%	96%

Note that the two-fund approach always gives a higher ending portfolio value and higher compounded return than the Roth CD and index fund combination. This ratio is in the right hand column above.

A traditional retirement portfolio is a 60:40 stock-to-bond ratio invested in low-cost stock and bond index funds. Below is a

table showing how this traditional 60:40 portfolio compares to Roth's scenario of the stock market losing 50% of its value:

Stock Market Return	Total Ending Value of Combination Total Bond and Total Stock with 60:40 AA	Entire 60:40 Portfolio Com-pounded Annual Return Rate	Ratio of CD and Total Stock Fund to 60:40 Total Bond and Total Stock Funds
-100%	\$65,156	-4.2%	120%
-6.70%	\$94,921	-0.5%	105%
-6%	\$97,233	-0.3%	104%
-4%	\$104,756	0.5%	102%
-2%	\$113,831	1.3%	100%
0%	\$124,737	2.2%	97%
2%	\$137,795	3.3%	95%
4%	\$153,374	4.4%	92%
6%	\$171,899	5.6%	90%
8%	\$193,854	6.8%	88%
10%	\$219,793	8.2%	86%
12%	\$250,345	9.6%	84%
14%	\$286,227	11.1%	83%
16%	\$328,249	12.6%	81%
18%	\$377,328	14.2%	80%
20%	\$434,499	15.8%	79%

Note that in poor stock market environments, Roth's CD and index fund option performs better than the traditional 60:40 portfolio. As long as the stock market has about a 0%

compounded return or higher, the traditional 60:40 portfolio wins out. The ratio between these two options is shown in the right-hand column above.

Roth's CD and index fund combination can be done in retirement accounts, so taxes would have no impact on the returns achieved. One major criticism of Roth's concept is lack of inflation protection. CD's offer no protection against high inflation. Stocks have a mixed historical record protecting against unexpected inflation.

To gain more protection against high inflation rates, Roth's concept can be modified. Instead of investing in CD's, individual TIPS (Treasury Inflation Protected Securities) or a TIPS mutual fund could be used. The stock portfolio could be more diversified with domestic stocks, international stocks, REITS, and funds which invest in commodity producing companies.

CHAPTER 10

Summary

Probably the best over-view of equity indexed annuities is given in the McCann and Luo paper:

Insurance companies add trivial insurance benefits, disadvantageous tax treatment and exorbitant costs to mutual funds and sell them as variable annuities. Insurance companies have added similarly trivial insurance benefits, disadvantageous tax treatment and exorbitant costs to equity-participation securities and sell them as equity-indexed annuities. The primary difference in the correspondence is that repackaging mutual funds as variable annuities doesn't remove investor safeguards whereas repackaging equity-participation securities as equity-indexed annuities has heretofore exempted them from effective securities regulation.

A direct consequence of the difference in regulatory treatment is that investors in unregistered equity-indexed annuities cannot trace back through returns in the markets to the returns their investments will earn. Also, as a result of the lack of SEC and NASD oversight, investors in equity-indexed annuities cannot determine the costs they are incurring. Moreover, equity-indexed annuities' complexity makes it virtually impossible even for brokers and agents to properly evaluate the annuities. Salesmen can readily determine though that commissions paid for selling equity-indexed annuities – as high as 10% or 12% – are much larger than commissions paid on mutual funds and variable annuities.

The other telling finding from the McCann and Luo paper is the price that investors pay when they invest in equity indexed annuities:

We estimate that between 15% and 20% of the premium paid by investors in equity-indexed annuities is a transfer of wealth from unsophisticated investors to insurance companies and their sales forces.

The Dateline story on equity indexed annuities dramatically illustrated how a huge commission can drive insurance agents to improperly represent equity indexed annuities to senior citizens.

Equity indexed annuities, in their current complex format, also violate Warren Buffett's basic guideline.....***Don't invest in something you don't understand.***



If you want to learn more low-cost immediate annuities as an option to equity indexed annuities, you can read my short story titled ***Should Immediate Annuities Be a Tool in Your Retirement Planning Toolbox?*** [31]

If you don't feel comfortable evaluating equity indexed annuities by yourself, you can get professional help. You can read my short story titled ***How to Find a Good Financial Planner.*** [32] You can also read Chapter 18 ***Seeking Professional Help*** from the ***Bogleheads' Guide to Retirement Planning***. I was a contributing author to that chapter.

If you would like to know more about the over-all financial planning process, you can read my short story titled ***How to Read Your Way to Financial Wealth.*** [33]

Hopefully you now have enough information to make your own well-informed decision about equity indexed annuities.

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Recommended Reading

Index Mutual Funds: How to Simplify Your Financial Life and Beat the Pros by Dale Maley.

The Bogleheads' Guide to Investing by Taylor Larimore, Mel Lindauer, and Michael LeBoeuf.

The Bogleheads' Guide to Retirement Planning by Taylor Larimore and others.

Web Sites

ImmediateAnnuities.com has instant quotes for immediate annuities.

Vanguard.com has educational materials including immediate annuities.

Fidelity.com has information on immediate annuities.

BRKDirect.com has quotes for immediate annuities.

TIAA-CREF.com has information on immediate annuities.

Bogleheads.org is an online forum. This forum focuses on Vanguard investments with many lively and informational discussions about investing during both the accumulation and distribution phases of life. Also covers immediate annuities. Equity indexed annuities are usually not covered because they are not generally recommended by Bogleheads.

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Dale C. Maley

Author Spotlight

Dale C. Maley is the author of the book ***Index Mutual Funds: How to Simplify Your Financial Life and Beat the Pros***. He was also a contributing author to Chapter 18 in the 2009 book ***The Bogleheads Guide to Retirement Planning***. Dale is a very successful private investor who has been a student of Financial Planning and Investing for over 32 years.

He was trained as an engineer at the University of Illinois and has been a practicing engineer for 33 years. His accomplishments as an engineer include the granting of 16 U.S. Patents and authorship of over 535 professional technical papers. He is also a member of the International Society of Automotive Engineers and the Society of Manufacturing Engineers.

Dale earned an MBA (Masters Degree in Business Administration) degree from Illinois State University. Dale became a Registered Financial Advisor in the State of Illinois in 2006 and is currently launching his business as a fee-only financial planner. He is President of Maley Financial Planning.

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Also by Dale C. Maley

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